FT.com FINANCIAL TIMES

A giant leap for Europe

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Published: April 25 2004 19:48 | Last Updated: April 25 2004 19:48

The word "historic" is over-used. But the addition of 10 new members to the European Union deserves that label. Just over 14 years after the fall of the Berlin Wall, Europe's political division is healing. Yet this is not true of the economic divide. Convergence of living standards will take many decades. For the new members, accession makes the commitment to western norms irrevocable. For the old members, it creates more anxiety than hope. But its impact is likely to be almost unnoticeable.

Apart from Cyprus and Malta, two tiny Mediterranean countries with populations of 760,000 and 400,000, respectively, the new members had socialist economies at least until 1989. Since then they have undertaken comprehensive reforms of their institutions and policies, which is why they can join the EU. The European Bank for Reconstruction and Development regularly assesses its clients' performance on privatisation, market liberalisation and reform of the financial and infrastructure sectors. Last year, the accession countries of central and eastern Europe had reached advanced country levels on small-scale privatisation and liberalisation of prices and trade. Overall, the leader was Hungary, followed by the Czech Republic, Estonia, Poland, Latvia, Lithuania, Slovakia and Slovenia.

By 2002, according to the EBRD's *Transition Report2003,* the average ratios of trade (imports plus exports) to gross domestic product (at purchasing power parity) of the accession countries were already above 50 per cent, up from 35 per cent in 1995, compared with 65 per cent for existing members of the EU. By 2002, the share of EU markets in the exports of the accession countries was 63 per cent, on average, up from 53 per cent in 1995. This is much the same proportion as existing EU members. The new members should become still more open to trade, but not dramatically so, while the reorientation of their trade towards the west is complete.

Between 1989 and 2003, cumulative inflows of foreign direct investment into the accession countries of central and eastern Europe were $117bn (£66,23bn, □98.94bn), with the largest quantities going to Poland ($42bn), the Czech Republic ($38bn) and Hungary ($21bn). In 2003, inflows were 8.3 per cent of Estonia's GDP, 2.8 per cent of the Czech Republic's and Latvia's, and 2.6 per cent of Lithuania's. In 2002, the inflow into the Czech Republic was 11.9 per cent of GDP. These inflows were made in anticipation of accession. For that reason, they are unlikely to accelerate dramatically thereafter.

With much of the transition from a socialist to a market economy behind them, the challenge confronting the accession countries is convergence on the living standards of the richest members of the EU. If real GDP per head rose two percentage points a year faster in the new members than in France, it would take 21 years for Slovenia and 57 years for Lithuania to catch up. With a superiority of only one percentage point a year, convergence would take

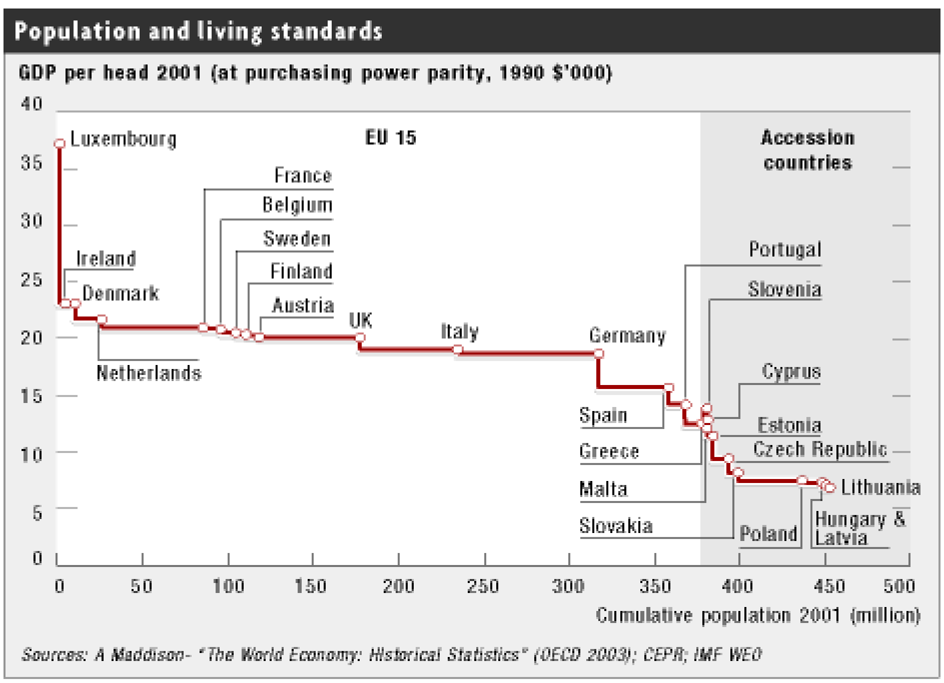
Winning at catch-up will take more than just club membership

All of the 10 new members of the European Union are poorer than all but one of the existing members (the exception is Greece). The Czech Republic, Slovakia, Poland, Hungary, Latvia and Lithuania are poorer, relative to rich between 42 and 113 years. To put this in context, GDP per head, at PPP, has risen about one percentage point a year faster in Spain than in France and 1.5 percentage points faster in Portugal since 1986. Ireland did far better, but Greece did worse.

Some omens are disturbing. The three largest accession countries (the Czech Republic, Hungary and Poland) have lost fiscal control: Poland, whose population is just over half of the total of the accession countries, had an average fiscal deficit of 6 per cent of GDP in 2001 to 2003. The average deficits of the Czech Republic and Hungary were similar. Poland's unemployment rate jumped from 13 per cent of the labour force in 1996 to close to 20 per cent last year. In the Czech Republic, as well, unemployment rose from 3.5 per cent to close to 10 per cent.

members of the EU, than were any previous members on accession. But experience suggests that such gaps in living standards provide an opportunity for relatively rapid growth and convergence towards the living standards of richer members.Read

The Transition Report 2003 stresses that these economies have made substantial progress on the road to becoming "efficient, well-functioning market economies but important gaps remain - for example in the breadth and depth of these countries' financial markets and . . . the restructuring of strategic sectors, such as energy, heavy industry and agriculture. There are also deficiencies in the quality of public administration . . . These weaknesses raise questions about the accession countries' capacities to absorb and use effectively the post-accession grants from the EU's cohesion and structural funds."

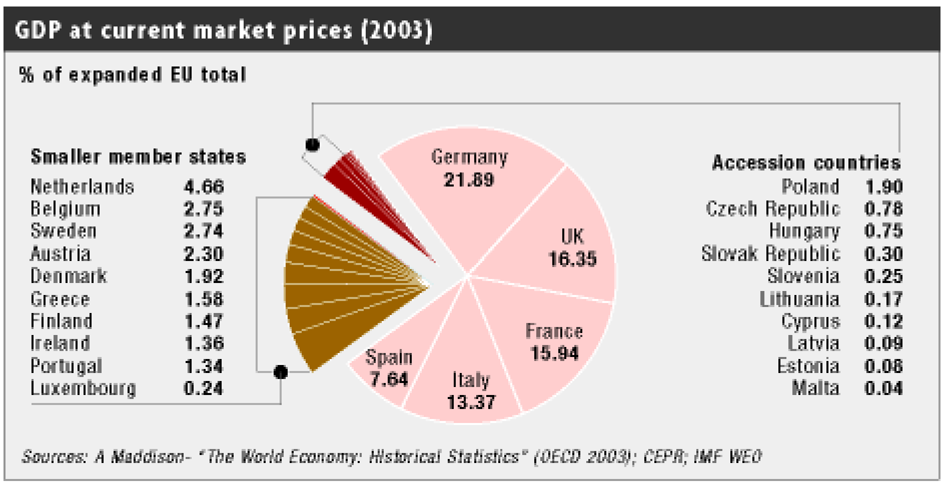


It may be no bad thing, therefore, that these funds are likely to be modest. Between now and the end of 2006, the EU has earmarked just over €40bn ($47.3bn, £26.8bn) for the new members. New members will also have to make contributions to the EU's budget, which will reduce net receipts to €10bn a year, or 0.1 per cent of the aggregate GDP of the EU. Decisions have not yet been made on what will happen after 2006, but there is no appetite for an increase in the share of GDP taken by the EU budget. The EU has already decided that it will take until 2013 before east European farmers are entitled to the same subsidies as those of the west. It has also capped regional aid to the new member states at 4 per cent of their respective GDPs. Perversely, aid will be smallest when countries are poorest.

Existing members fear both the competitiveness of the accession countries and, inconsistently, floods of immigrants from them. In practice, the economic impact of enlargement upon them will be both modest and benign.

The accession increases the population of the EU by a fifth, but the size of the economy by less than 5 per cent, at market prices (see charts). If all went astonishingly well, the accession could add another Germany to the EU. Today, it adds another Netherlands. Moreover, much of the market opening has occurred. Yet imports from the accession countries are still only about 1 per cent of the existing EU's GDP, while these countries have run large trade deficits with the rest of the EU.

Wages in central and eastern Europe are far below western levels, which will continue to attract inward investment. For some member states - Spain, for example - the competition could be significantly adverse. But the most advanced member states should welcome the lower prices and the opportunity for their companies to address global competition by locating labour-intensive production in neighbouring countries with low wages. This is particularly relevant for Germany, though this gain may be seen as coming at the expense of the languishing economy of the former East Germany.



The most controversial of all topics associated with enlargement, for existing members, is migration. Some members, notably Germany and Austria, have insisted on the right to keep restrictions on the movement of workers for up to seven years after accession. This is politically understandable, given the high level of unemployment in their countries. But the worries are almost certainly exaggerated. Most analyses suggest the migrants will be young and relatively skilled. Since they will, in time, be able to come and go freely, these migrants are also likely to be temporary. Studies converge in predicting that the long-term migration potential may be about 3 per cent of the current population of the accession countries, or 0.6 per cent of the population of the existing members.* Nobody knows what will happen, but this seems to be much ado about very little.

A further contentious issue is likely to be entry into the euro. Some of the accession countries - notably Estonia - could join tomorrow if permitted to do so. Others are far from meeting the criteria, notably on fiscal policy. These are countries that ought to benefit from the low inflation and stability-oriented policies of the eurozone. Their entry could also create some difficulties for the existing members, because rapidly growing economies should have higher inflation than the others. But the effect will be very small.

The two halves of Europe are uniting politically. They should, over a far longer period, converge economically. But they will do so only if mistakes are avoided. The countries that will need to work hardest are the accession countries. But there are also mistakes to be avoided by existing members. The biggest would be to cripple the competitiveness of the new members by imposing excessive regulations and onerous costs. A further danger is for the new members to push for greater protection against labour-intensive imports from the rest of the world.

Anxiety is inevitable. But enthusiasm should vastly outweigh it. Europe is uniting peacefully, at last. The EU offers the promise of freedom and the hope of prosperity across the continent. That was always its purpose. This enlargement marks a big step towards the fulfillment of that destiny.

** Tito Boeri and others, Who's Afraid of the Big Enlargement? CEPR Policy Paper No.7, 2002, www.cepr.org.*

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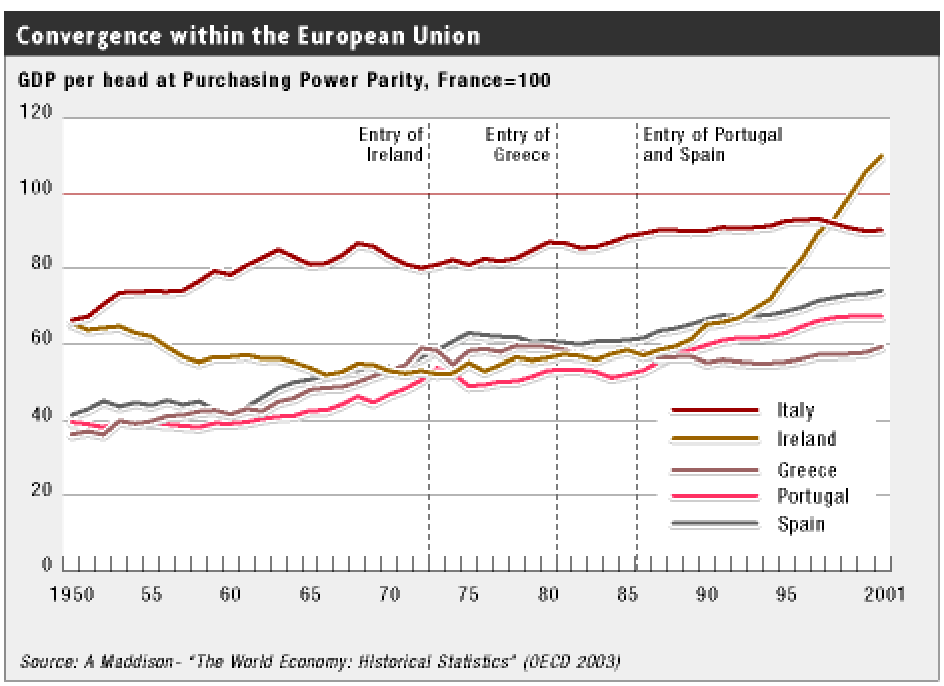
Winning at catch-up will take more than just club membership

All of the 10 new members of the European Union are poorer than all but one of the existing members (the exception is Greece). The Czech Republic, Slovakia, Poland, Hungary, Latvia and Lithuania are poorer, relative to rich members of the EU, than were any previous members on accession (see chart). But experience suggests that such gaps in living standards provide an opportunity for relatively rapid growth and convergence towards the living standards of richer members.

Of the EU's existing members, five were relatively poor when they joined: Italy, a founding member; Ireland, which joined in 1973; Greece, which joined in 1981; and Portugal and Spain, which joined in 1986. The chart takes as a benchmark the gross domestic product per head, at purchasing power parity, of France, a big founding member: Germany is ineffective as a comparison because of its unification in 1990.

In 1952, when the European Coal and Steel Community - the forerunner of the EU - was launched, Italy was the poorest member, with a GDP per head, at PPP, of 71 per cent of French levels. It performed relatively well in the 1950s and 1960s and again, after a pause, in the 1980s and early 1990s (see chart). In 1950, Ireland was as rich as Italy. Its decline, prior to 1973, suggests that membership boosts growth. Yet Ireland's post-1973 experience also shows that membership is not a sufficient condition for convergence. In 1973, Ireland's GDP per head, at PPP, was 52 per cent of French levels. It passed 60 per cent only 16 years later. But its output per head then exploded, passing that of Italy in 1998 and France in 2000.

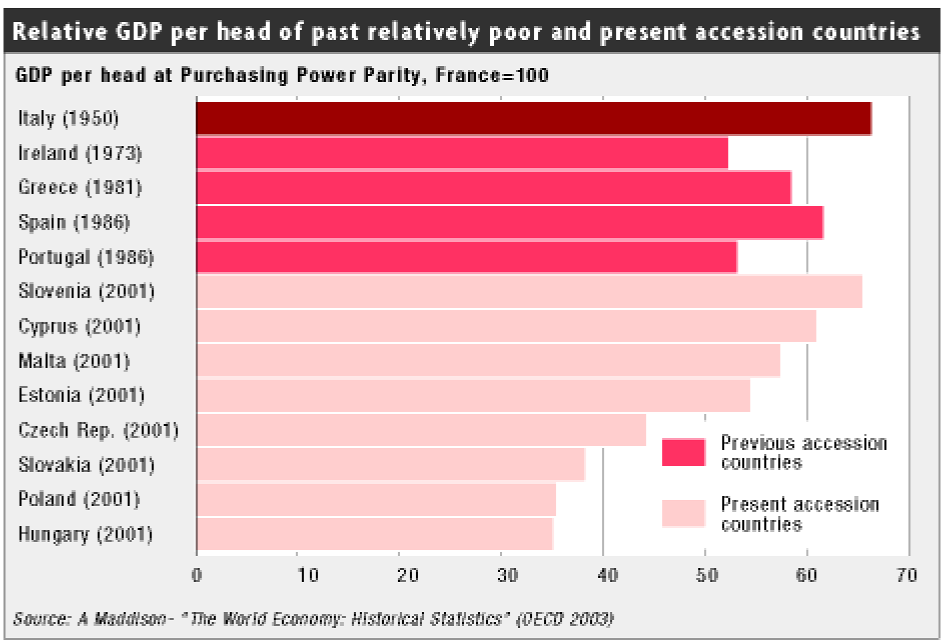


Greece's fate underlines the lesson that membership does not guarantee convergence. Cursed with the irresponsible government of Andreas Papandreou (prime minister between 1981 and 1989 and then 1993 and 1996), Greece experienced more than a decade of relative decline after accession. Under Costas Simitis it began to catch up. Nevertheless a country that had, until 1986, a higher GDP per head, at PPP, than Ireland and, until 1987, a higher GDP per head than Portugal is much the poorest country in the existing EU.

The experience of Spain and Portugal is better, but not as stellar as Ireland's. Between accession and 2001, Spain's GDP per head rose from 62 per cent to 74 per cent of French levels, while Portugal's rose from 53 per cent to 68 per cent.

EU membership is, it appears, far from a sufficient condition for convergence of poorer countries on the incomes of the rich. But membership can help, as the experiences of Italy, Ireland, Spain and Portugal all show.

It is mistakenly believed that the money transferred from the EU budget has been the principal explanation for success in convergence. This is most strongly believed of Ireland, which received 7 per cent of GDP from the EU's "structural funds" in the early 1990s. Yet if extra money were all that was needed, it would not have taken Ireland almost two decades to go from accession to accelerated growth. Nor would Greece have failed so signally. While Ireland received larger transfers per head than Greece, Portugal and Spain, the difference is not large enough to explain its superiority.



The chief determinant of success is not money, but how well a country exploits the wider advantages of membership. The EU gives guarantees of durable free trade with natural trading partners and of free movement of capital and labour. Where countries have exploited these opportunities, results have been remarkable. Between 1985 and 2002, the ratio of the stock of inward foreign direct investment to GDP rose from 5 per cent to 33 per cent in Spain and from 19 per cent to 36 per cent in Portugal. But in Greece, it *fell*, from 20 per cent to 9 per cent. The ratio fell in Ireland, too, from 164 per cent in 1985 to 129 per cent in 2002, but it fell to 61 per cent in 1995 before risin g again.

To understand why success is not automatic, however, one should look at one of the most important indicators of stability: fiscal discipline. Greece ran fiscal deficits of close to 10 per cent of GDP until 1996. The ratio of its public debt to GDP exploded from 48 per cent in 1986 to 111 per cent a decade later.

Portugal and Spain did better than that, but still ran sizeable deficits until the mid-1990s. Ireland stopped its fiscal rot in the late 1980s: the ratio of its public debt to GDP fell decisively, from a peak of 112 per cent in 1987 to 38 per cent by 2000. Not coincidentally, growth accelerated.

EU membership, then, helps those prepared to help themselves. Membership provides only opportunities, not guarantees. But these are well worth seizing.